Internal Revenue Service

memorandum

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Br2:LSMannix

date: JUL 22 1988

to: Special Trial Attorney, International and Staff Attorney, Southwest Region

from: Director, Tax Litigation Division CC:TL

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subject: Preferred Stock Transactions Between [redacted] and the [redacted] -- Years [redacted] through [redacted] - nondocketed

Pursuant to your request for technical advise received in April of this year, enclosed is our conclusions on the three issues presented.

ISSUES

[redacted] 1. Whether the [redacted] preferred stock received by the [redacted] in exchange for their [redacted] common stock was, in fact, debt, causing the transaction to be a recognizable event rather than a type "E" reorganization. 2/

2. If the preferred stock at issue was, in fact, stock, whether the difference between its fair market value and the market quotations on the [redacted] common stock must be recognized by the [redacted] as gain. See Rev. Rul. 74-269, 1974-1 C.B. 87.

1/ The taxpayers under examination will be collectively referred to as the "[redacted]." The [redacted] are:

[redacted]

2/ A recapitalization pursuant to section 368(a)(1)(E) (all section references are to the Internal Revenue Code of 1954) is commonly referred to as a 'type "E" reorganization.'

3. If the preferred stock at issue was, in fact, stock, whether the corporate [redacted] are entitled to claim an [redacted] percent dividend received deduction on the preferred stock dividends.

Conclusions

1. The first issue should not be conceded. However, additional evidence of the parties' intent to create a debt instrument must be uncovered in order to support the position that the preferred stock was, in fact, debt.

2. The second issue should be conceded.

3. The third issue should be conceded.

FACTS

On [redacted] the [redacted] entered into an agreement with [redacted] (hereinafter referred to as the "agreement") to convey all the [redacted] common stock owned by the [redacted] to [redacted] in exchange for cash and newly issued [redacted] preferred stock. [redacted] shares of [redacted] common stock were exchanged for $[redacted] cash, for a purchase price of $[redacted] per share; and [redacted] shares of [redacted] common stock were exchanged for an equal number of [redacted] preferred stock, Series A, with a stated value of $[redacted] per share.

[redacted] common stock closed on [redacted] at $[redacted] per share although it had reached $[redacted] per share earlier in the day. It opened at $[redacted] per share on [redacted] (after the agreement was made public).

Pursuant to the agreement, the [redacted] were prohibited from reconveying the preferred stock with one exception. If between [redacted] and [redacted] the [redacted] made a demand on [redacted] to register the shares pursuant to Rule 415 of the Securities Act of 1933 (Shelf registration), they could sell the stock once it was registered. However, upon a demand for registration, [redacted] had the option under the agreement to purchase all the shares of the preferred stock at $[redacted] per share.

([redacted], in fact, purchased all the preferred stock owned by the [redacted] on [redacted] for $[redacted] per share, after the [redacted] had made a demand for registration.)

The agreement also bound each of the [redacted] to "use its best efforts" to cause the [redacted] to vote the preferred stock in a manner recommended by the Board of Directors of [redacted].

The agreement also prohibited the [redacted] from acquiring any [redacted] voting stock or participating in any solicitation of proxies until [redacted]. (This is commonly known as a stand still agreement). This provision would be nullified, however, if [redacted] failed to pay any dividend on, or make any mandatory redemption of, the preferred stock.

Pursuant to a resolution by the Board of Directors of [redacted], a Certificate of Designation (hereinafter referred to as the "Certificate") was produced providing for the description, rights and limitations of the preferred stock. The Certificate was expressly included in the agreement between the [redacted] and [redacted].

Pursuant to the Certificate, the stated value of the preferred stock was $[redacted] per share. The dividend rate was tied to Treasury rates and the dividends were cumulative. [redacted] was required to redeem the preferred stock for $[redacted] per share plus accrued and unpaid dividends at a rate of [redacted] percent per year starting in year six. Each share of preferred stock was entitled to one vote, to be voted as a single class with the holders of [redacted] common stock. If any dividends on the preferred stock were in arrears the directors constituting the Board of Directors would be increased by two and the holders of the preferred stock would have the exclusive right to elect two director to the Board until the arrearage was corrected.

Pursuant to the Certificate, upon liquidation the holders of the preferred stock were entitled to $[redacted] per share plus all accrued and unpaid dividends, but only after all the creditors of [redacted] had been satisfied. The holders of the preferred stock were ranked below the general creditors of [redacted] but above the holders of [redacted] common stock. It was possible that other series of preferred stock would rank on a parity with the preferred stock at issue.

There was no provision in the agreement or Certificate to pay dividends on the preferred stock out of anything but the earnings of [redacted]. The agreement and Certificate consistently labelled and treated the preferred stock as stock. There was no provision in the agreement or Certificate that gave the holders of the preferred stock any recourse upon default other than the nullification of the stand still provision and the exclusive right to elect two directors to the Board of Directors, as discussed above.

Finally, there is evidence to indicate that the [redacted] did not intend to maintain a prolonged investment in [redacted]. Apparently, the reason for the transaction was a disagreement between [redacted] who represented the [redacted] and [redacted], [redacted] of [redacted], on the future of [redacted] Thus, [redacted] wanted to rid itself of disruptive shareholders. In addition, numerous newspaper and magazine articles referred to the transaction as a "buy-out" and referred to the premium paid for the [redacted] common stock as "[redacted]."

DISCUSSION

Issue 1:

Pursuant to the transaction at issue, the [redacted] recognized gain on the receipt of the $[redacted] cash in exchange for their [redacted] common stock. The gain was either ordinary or capital depending on how long the [redacted] owned the specific shares. However, on the exchange of the [redacted] common stock for the [redacted] preferred stock the [redacted] did not recognize any gain. The [redacted] claim that that part of the transaction was a recapitalization, pursuant to section 368(a)(1)(E), and that section 354(a) allowed for the nonrecognition of gain.

The [redacted] are correct that if all the requirements of sections 368(a)(1)(E) and 354(a) are met the exchange of the [redacted] common stock for [redacted] preferred stock would be a nonrecognition event. See Rev. Rul. 74-269, 1974-2 C.B. 87. However, section 354(a) would not apply if the preferred stock was, in fact, debt. See Rev. Rul. 77-415, 1977-2 C.B. 311; Section 354(a)(2)(A)(ii); Treas. Reg. § 1.354-1(b) and (d) example (3).

The issue of whether a particular instrument is debt or equity has a long and unpleasant history. The area is controlled by case law because both Congress and, for the most part, the Service have opted not to issue guidelines. 3/

Unfortunately, the extensive case law is often conflicting because the issue is primarily a question of fact. Most courts, however, have used a checklist of relevant factors to determine whether a particular instrument is debt or equity. See Fin Hay Realty Company, 398 F.2d 694 (3rd Cir. 1968). The same factors are relevant whether the Service is arguing that the instrument is debt as opposed equity or vise versa. See Ragland Investment Company v. Commissioner, 52 T.C. 867, 875 (1969); Zilkha & Sons, Inc. v. Commissioner, 52 T.C. 607, 612 (1969); Lupowitz v.

3/ The regulations pursuant to section 385 never became effective and the Service does not issue advanced rulings. Rev. Proc. 87-3, § 4.02(1), 1987-1 C.B. 523.

Commissioner, T.C. Memo. 1972-238, at 1174.

The most important of these factors are (1) the intent of the parties, which would include the label the parties give the instruments; (2) the source of the dividends or interest on the instruments, i.e., whether they are payable only out of earnings; (3) the holder's position relative to other creditors; and (4) the holder's rights on default. See Ragland, 52 T.C. at 876; and Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders ¶¶ 4.01-4.03 (5th Ed. 1987).

The intent of the parties is the single most significant factor because if the question as to whether an instrument is debt or equity is at all close, a court will most likely decide the issue on this basis. Furthermore, because a court can not magically decipher the parties' intent, it will look to objective evidence of intent. The most important piece of evidence in this respect is the label the parties give the instrument.

In the instant case, whether the preferred stock at issue is debt or equity is a close call. The preferred stock was also consistently called preferred stock. Thus, the Government is starting off with two strikes against it.

To counter this weakness, the Government will have to argue that the parties intended to create an instrument that had, for all practical purposes, the characteristics of debt, but for some reason, was called stock.

The evidence shows that the purpose of the transaction at issue was to eliminate the [redacted] holding in [redacted]. As stated in the "Facts," a disagreement arose between [redacted] and the [redacted]. Thus, it appears that the [redacted] were not interested in a prolonged investment in [redacted], which is an attribute of a stockholder, but were simply trying to have their capital returned as soon as possible.

Furthermore, a large portion of the [redacted] holdings in [redacted] common stock was purchased in [redacted]. It appears that this was the stock that was exchanged for the preferred in [redacted]. By exchanging the common stock for preferred in an allegedly valid type "E" reorganization and by waiting a year until [redacted] bought back the preferred stock, the [redacted] converted what would have been a short-term capital gain into a long-term capital gain.

In sum, this evidence suggests that the only reason the [redacted] wanted to prolong their investment was so that they could avoid recognizing short-term capital gain when [redacted] bought out their interest. Naturally, the [redacted] would have wanted to insure payment for their [redacted] common stock at a price set by them so they took in exchange preferred stock with cumulative dividends tied to Treasury rates and subject to a mandatory redemption; i.e., an instrument that had most of the characteristics and safe guards of debt.

However, in order for the Government to be successful on this first issue, other evidence of the intent of the parties must be obtained. In this respect, the corporate minutes of [redacted] should be searched and investigations should be made into how [redacted] has treated the so called dividends on the preferred stock.

In addition, another possible avenue that should be considered is whether [redacted] could afford to pay for the [redacted] entire holding in [redacted] common stock. Having just bought [redacted], [redacted] may have been burdened with debt and short of cash. Thus, the parties disguised as preferred stock what was in reality short term debt.

The next three factors, listed above, go to the issue of whether the instrument itself has characteristics of debt or equity. Pursuant to state corporate law, dividends on stock are normally payable only out of the earnings or surplus of a corporation. Interest on debt, on the other hand, is payable out of capital. A corporation is normally under a contractual obligation to pay the interest on its debt, whereas payment of dividends are usually discretionary. Even with cumulative preferred stock, the dividends can only be paid from earnings. A creditor is, in effect, guaranteed his return and must be paid in all events. A stockholder, on the other hand, must rely on the fortunes of the corporation and hope for profits.

[redacted] is incorporated in the state of Delaware, and thus, Delaware corporate law controls with respect to its securities. Delaware corporate law states that dividends on stock, preferred or otherwise, are payable only out of the earnings of a corporation. Del. Code Ann. tit. 8, § 170 (1983). However, Delaware state law allows preferred stock to be redeemed out of the capital of a corporation, as long as the corporation is not insolvent and will not become insolvent as a result of the redemption. Furthermore, the Court of Chancery of the State of Delaware has held in an unreported case that the redemption price of preferred stock would include accrued but unpaid dividends if the redemption price so states in the appropriate document, such as a certificate of designation. Del. Code Ann. tit. 8, § 160(a)(1); Baron v. Wolf, Del. Ch. C.A. No. 4972 (January 15, 1976). Thus, in effect, the state of Delaware allows dividends to be paid out of capital if it is part of the redemption price of preferred stock.

In the instant case, there is nothing in the agreement or the Certificate of Designation that states that the dividends on the preferred stock was payable out of anything but the earning or profits of [redacted]. However, the preferred stock at issue was subject to a mandatory redemption and the Certificate of Designation includes in the redemption price accrued but unpaid dividends. Thus, the dividends on the preferred stock at issue could have been paid out of the capital of [redacted] if [redacted] did not have earnings to pay the dividends as they accrued. In effect, the [redacted] were like creditors and would have been paid the dividends as long as [redacted] remained solvent. This tends to show that the dividends on the preferred stock were more like interest, and thus, the preferred stock was more like debt.

It may be argued that the [redacted] were not like creditors because if [redacted] became insolvent, the preferred stock could not be redeemed. The contingency is not so far fetched considering [redacted] entered bankruptcy some years later. However, to the [redacted] at the time they entered into the agreement with [redacted] the possibility of insolvency would have seemed extremely remote. Thus, the [redacted] would have been willing to depart with such a safe guard, while still maintaining other safe guards of debt, in order to reap the tax benefits.

The third factor to be considered is the relative position of the [redacted] to other creditors. The preferred stock ranked above the common stockholders but below the general creditors. In a liquidation, the general creditors would be paid off in full before the preferred stockholders would receive any portion of the assets. This is normally the position taken by preferred stockholders and tends to show that the preferred stock was, in fact, stock.

This factor may be countered, however, by arguing that the [redacted] surely would have assumed that [redacted], one of the [redacted] corporations [redacted], would not be liquidated any time in the near future, and thus, they would not fear this contingency.

The fourth factor is the [redacted] remedy upon default. Normally, a stockholder has no remedy when a corporation does not pay dividends or fails to redeem redeemable stock. However, as stated above, the preferred stock at issue was subject to a mandatory redemption, which could have included accrued but unpaid dividends, and the stock could have been redeemed out of the capital of [redacted]. Therefore, the [redacted] could have demanded that the preferred stock be redeemed as long as [redacted] was not insolvent and would not be made insolvent by the redemption. In fact, the [redacted] probably could have instigated legal action to have the stock redeemed. Thus, the [redacted] have for all practical purposes an effective remedy upon default.

This factor is the strongest in favor of the position that the preferred stock was actually debt. An enforceable mandatory redemption out of the capital of a corporation, which could include accrued but unpaid dividends, looks suspiciously like the maturity of a debt instrument that pays principal plus interest.

It should also be noted, that some courts have even said that a fixed maturity date is the most significant factor in deciding whether an instrument is debt or equity. See United States v. Title Guarantee & Trust Company, 133 F.2d 990, 993 (6th Cir. 1943). Unfortunately, the lack of a mandatory redemption is much more damaging to a claim that an instrument is debt than the existence of a mandatory redemption is helpful to the same claim. See Bittker and Eustice, supra, at 4-16. The reason is that it is not uncommon for preferred stock to be at least redeemable if not subject to a mandatory redemption.

Ragland Investment Company v. Commissioner, 52 T.C. 867, is the dominant case in which the Commissioner argued that the instrument at issue was debt rather than equity. The instrument in Ragland was called cumulative 6-percent preferred stock. The shareholders of the corporation contracted to use their best effort to have the preferred stock redeemed after 4 years and the holder of the instrument, Ragland Investment Company, was given the right to name two members to the board of directors. Ragland Investment Company had no remedy if no dividends were paid or if the stock was not redeemed. The Tax Court, with five judges dissenting, held that the instrument was, in fact, stock.

Ragland is distinguishable from the instant case in that the preferred stock was subject to a mandatory redemption and, as shown above, the [redacted] had an effective remedy upon default. Furthermore, the [redacted] had to vote their shares as the management of [redacted] directed, which is the same as having no vote at all. The instant case is also stronger than the Commissioner's position in Ragland for the same reasons.

Choctaw v. Commissioner, 12 T.C.M. 1393 (1953), and United States v. Title Guarantee & Trust Company, 133 F.2d 990 (6th Cir. 1943), support the position that the preferred stock at issue was, in fact, debt. In both cases the cumulative preferred stock, which was subject to a mandatory redemption, was held to be debt instead of equity as the Government had argued.

In conclusion, the first issue should not be conceded. It appears that [redacted] and the [redacted] intended to create a debt instrument but called it stock so that the [redacted] could receive preferable tax treatment. However, additional evidence on the intent of the parties must be uncovered to support the position that the preferred stock was, in fact, debt.

Issue 2:

The second issue is relevant only if it is determined that the [redacted] preferred stock at issue was, in fact, stock.

Section 368(a)(1)(E) includes within the term "reorganization" a "recapitalization." A recapitalization has been described by the Supreme Court as a "reshuffling of a capital structure within the framework of an existing corporation." Helvering v. Southwest Consolidated Corporation, 315 U.S. 194, 202 (1942).

Section 354(a)(1) states that no gain or loss shall be recognized by a shareholder if stock or securities of a corporation that is a party to a reorganization is exchanged solely for stock or securities of such corporation.

Rev. Rul. 74-269, 1974-1 C.B. 87 states that the exchange of outstanding common stock for newly issued preferred stock is a reorganization within the meaning of section 368(a)(1)(E) and no gain is recognized provided that the fair market value of the preferred stock equals that of the common stock. The revenue ruling states that if the value of the preferred stock exceeds that of the common, the excess will be treated as having been used for whatever purpose the facts indicate. Such purpose may be to make a gift, pay compensation or satisfy an obligation.

There are no reported cases that have addressed the issue of whether there must be an exchange of equal value in order for no gain to be recognized in a type "E" reorganization. However, there are numerous private letter rulings with such a requirement. See LTR 77-34-057 (Aug. 26, 1977); LTR 82-218-023 (April 30, 1982); LTR 82-11-090 (March 12, 1982).

Rev. Rul. 74-269 also states that: "the fair market value of stock is a factual determination and is not necessarily the book value or par value of the stock." Normally, fair market value is described as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." Treas Reg. § 20.2031-1(b), as quoted in United States v. Cartwright, 411 U.S. 546, 551 (1973). In the context of stock that is traded on an exchange, the best evidence of fair market value is usually a current quotation. DeVito v. Commissioner, T.C. Memo. 1979-377.

However, current quotations are not necessarily controlling. United States v. Bailey, 707 F.2d 19 (1983).

The preferred stock at issue was not traded on an exchange but its value can be easily determined. From the [redacted] point of view --a willing buyer-- the value of the preferred stock must have been equal to $[redacted] per share because they accepted $[redacted] per share in cash for identical [redacted] common stock in the same transaction. Other evidence of the preferred stock's value include the facts that it was redeemable for $[redacted] per share, it was subject to [redacted]'s option to repurchase at $[redacted] per share and it had a stated value of $[redacted] per share.

The [redacted] common stock, on the other hand, was traded on the New York Stock Exchange. As stated in the "Facts," [redacted] common stock closed on the day before the agreement was executed at $[redacted] per share and reached a high on that day of $[redacted] per share. However, as just stated above, [redacted] paid $[redacted] per share, both in cash and in preferred stock, for the [redacted] common stock.

The issue is whether the premium above the market quotations, that [redacted] paid for the common stock, is attributable to its fair market value or to some other factor for which gain would have to be recognized.

Unfortunately, there is no evidence to indicate that the premium was attributable to anything other than the fact that the [redacted] were able to demand $[redacted] per share. As stated in the "Facts," [redacted]'s reason for buying out the [redacted] interest in [redacted] common stock was to rid itself of disruptive shareholders. The [redacted] may not have had a controlling interest in [redacted] common stock, but the very fact that the private placement at issue took place shows the influence the [redacted] had on [redacted]. Thus, the [redacted] would have a strong argument that they were able to demand $[redacted] per share for their [redacted] common stock because that was what their block of stock was worth.

Arguments can be made that the premium paid for the common stock was attributable to either the stand still provision in the agreement or to "greenmail." However, both these arguments are flawed. First, it is the Service position, at least when viewing a stand still provision from the corporation's side of the transaction, that no portion of the amount paid for stock can be allocated to a stand still provision unless the agreement between the parties expressly makes such an allocation. In the instant case, there is nothing in the agreement and no other evidence to indicate that the premium was for the stand still provision. Thus, we do not believe it should be argued that some portion of the payment should be allocated to the stand still agreement.

Second, it is also Service position that greenmail is part of the purchase price of the shareholder's stock, and as such, it receives capital gains treatment. Thus, to argue that the premium was not part of the purchase price of the stock and should be recognized by the [redacted] as gain would also conflict with Service position.

In conclusion, the Service's position on this issue is extremely weak. There is a strong argument that the price paid for the [redacted] common stock was actually its fair market value and there is nothing concrete to which the premium can be attributed. In light of the above, the second issue should be conceded.

Issue 3:

The third issue is relevant only if it is determined that the [redacted] preferred stock at issue was, in fact, stock.

Several of the [redacted] are corporations. During the period in which they held the preferred stock ([redacted] through [redacted]) they received dividends, [redacted] percent of which was deducted from their gross income pursuant to section 243(a).

Section 246(c)(1) 4/ states that no deduction shall be allowed under section 243 with respect to a dividend on stock if the stock is sold or otherwise disposed of within 16 days of the date the stock was acquired. (The 90 day holding period does not apply in this case. See Section 246(c)(2).) Section 246(c)(3) states that the holding period of the stock is reduced by "any period (during such holding period) in which the taxpayer has an option to sell, is under a contractual obligation to sell, or has made (and not closed) a short sale of, substantially identical stock or securities."

The issue is whether section 246(c)(3) applies to reduce to zero the corporate [redacted] holding period in the preferred stock because the stock was at all times subject to redemption. If the holding period is reduced to zero, section 246(c)(1) would arguably apply to deny the dividend received deduction because the corporate [redacted] would have held the preferred stock

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4/ The 1984 amendments to section 246(c) do not apply because the corporate [redacted] received the preferred stock before July 18, 1984. See The Deficit Reduction Act, Pub. L. No. 98-369, § 53(e)(2), 98 Stat. 494, 568 (1984).

for less than 16 days.

The intended application of section 246(c) is to prevent the situation where a corporate taxpayer buys a stock just prior to the record date and then sells it soon after, thereby collecting the dividend with the dividend received deduction and taking a short term capital loss. An example will illustrate. A corporate taxpayer buys stock for $5250.00 just prior to the record date for dividends. The price reflects the $250.00 dividend that will be paid to those stockholders that are holders on the record date. After the record date the price of the stock drops to $5000.00, reflecting the absence of the dividend. The corporate taxpayer then sells the stock and takes a $250.00 short term capital loss to use against other short term losses. However, he also collects the $250.00 dividend and takes the 85 percent dividend received deduction.

Originally, Congress made the decision that section 246(c) should apply only if the corporate taxpayer held the stock for less than 16 days (less than 91 days for preferred stock with dividends in arrears for a period in excess of 366 days). The inference was that if the corporate taxpayer held the stock for a longer period, his purpose for owning the stock must not be to engage in the abuse illustrated above because the longer he held the stock the more likely price fluctuations would prevent the success of such a scheme. Section 246(c)(3) was added to prevent the possibility that the corporate taxpayer would hedge during the time he held the stock to guard against fluctuations in price. Thus, even if the corporate taxpayer held the stock for more than 15 days, if he had hedged against a drop in price during that period, he would still get caught by section 246(c)(1).

It would be a very long stretch to infer that Congress intended section 246(c)(3) to apply to redeemable preferred stock that was not redeemable until years after the corporate taxpayer actually disposed of the stock. The section itself does not include redeemable preferred stock as a type of hedging maneuver and nowhere in the legislative history to section 246(c) is redeemable preferred stock mentioned. However, H.R. Rep. No. 861, 98th Cong., 2nd Sess. 818, _reprinted in_ 1984-3 C.B. Vol. 2 73, does state that the holder of a "single instrument that is designed to insulate the holder from market risks (e.g., adjustable rate preferred stock that is indexed to the Treasury bill rate)" does _not_ fall within the "substantially similar standard" of section 246(c)(3). Thus, the preferred stock at issue would clearly not fall within section 246(c)(3) if it were not redeemable.

[redacted] was not _required_ to buy back the stock at $[redacted] per share upon demand for registration and the corporate [redacted] had no guarantee that their preferred stock would not decline in value. In fact, they could not even sell their stock for the entire year that they owned it. Furthermore, the corporate [redacted] did not purchase the preferred stock just prior to the record date, did not soon after sell the stock, and did not recognize a short term capital loss. Thus, the Government would have a tough time arguing that the redeemable preferred stock at issue was a hedging maneuver within the meaning of section 246(c)(3).

In sum, section 246(c)(1) does not apply to disallow the dividend received deduction in the instant case because section 246(c)(3) could not legitimately be applied to the redeemable preferred stock at issue. Furthermore, the abusive scheme that section 246(c) was meant to prevent did not occur. In light of the above, the third issue should be conceded.

Recommendation

1. We recommend that the first issue not be conceded. However, additional evidence on the intent of the parties to create a debt instrument must be uncovered.

2. We recommend the second issue be conceded.

3. We recommend the third issue be conceded.

MARLENE GROSS

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